United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

76-6161

United States Court of Appeals

FOR THE SECOND CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

—against—

GALAXY FOODS, INC., ARTHUR LIEBERMAN a/k/a ARTY LEE, RALPH AVNI, CHARLES HOROWITZ, BRUCE KATZ, STEVEN ROTH, MARK GLAZER, IRWIN DONALD KIRSCHENBLATT a/k/a DONALD KIRSCH, GEORGE PADILLA, ARTHUR SHEVACK,

Defendants,

IRWIN DONALD KIRSCHENBLATT a/k/a DONALD KIRSCH and ARTHUR SHEVACK,

Defendants-Appellants.

BRIEF OF APPELLANTS, KIRSCH AND SHEVACK

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BRIEF OF APPELLANTS, KIRSCH AND SHEVACK

Statement of the Case

This action was commenced against Galaxy Foods, Inc., a New York corporation, its shareholders and directors, to wit, Messrs. Lieberman, Avni and Horowitz, and six franchisees of the firm, to wit, Messrs. Katz, Roth, Glazer, Padilla, Kirsch and Shevack. The complaint alleges violations of sections5(a), 5(c) and 17(a) of the Securities Act of 1933, [as amended 15 U.S.C. Sec. 77e(a), 77e(c) and

77q(a)], Section 10b of the Securities Exchange Act of 1934 [as amended 15 U.S.C. Section 78j(b)], and Rule 10b-5 promulgated by plaintiff under 17 C.F.R. Section 240, 10b-5.

The defendant corporation filed a voluntary petition in bankrupcty and the action against it was thereupon stayed. All other defendants, save appellants Kirsch and Shevack, consented to the entry of judgment against them.

The action proceeded to trial against Kirsch and Shevack on September 30, 1974. By decision dated July 26, 1976, *S.E.C.* v. *Galaxy Foods, Inc.*, 417 F. Supp. 1225, the Honorable Edward R. Neaher of the United States District Court, Eastern District of New York, held that both Kirsch and Shevack had violated the registration and anti-fraud provisions of the Securities Acts. He ordered that these two defendants be permanently enjoined from further violation, and that Kirsch and Shevack disgorge themselves of $3,700.00 and $8,250.00, respectively. A judgment was entered on September 13, 1976 based upon Judge Neaher's decision and provided for the injunctive and disgorgement relief above specified.

Questions Presented

1. Is the sale of a franchise which confers upon the franchisee the right to sell food at retail the sale of a security under the 1933 or 1934 Securities Acts, as amended?

2. If the answer to the foregoing is in the negative, does the granting by the franchisor to the franchisee of a gratuitous, non-contractual privilege to sell and earn commissions from the sale of additional franchises create a security out of the franchise?

3. If the answer to the foregoing question is in the affirmative, is a franchisee who sold a franchise which did not confer a contractual right to sell additional franchises, liable for violation of the Securities Acts and subject to injunctive relief and disgorgement of monies earned from such sales?

Facts

The record is silent as to why the six defendant franchisees, to wit, Messrs. Shevack, Kirsch, Padilla, Glazer, Katz and Roth, were, alone, selected out of the approximately 1,000 franchisees of the defendant corporation against whom plaintiff would proceed. However, Katz, Roth and Glazer were "insiders", closely tied to the promoters; Padilla was the leading franchise salesman.

Kirsch joined the defendant corporation in or about August, 1971. His primary duties involved the retail marketing of food, which, by contract, the corporation had licensed its franchisees to sell to the general public (127).*[1]

Kirsch at no time was a corporate director or shareholder. His franchise was given to him by the corporation without cash consideration (36).

Shevack joined the corporation as a franchisee in or about June, 1972 (1471). He at no time was a corporate officer, director or shareholder. His franchise was paid for through the allocation of commissions earned by him for services rendered in connection with the sale of other franchises (1474). Neither Kirsch nor Shevack were among the top ten franchise salesmen of the corporation.

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* (Numbers in parenthesis refer to pages of transcript.)

[1] His title was Vice President of Marketing.

The term "director" has been misused and has caused confusion in the course of this litigation. As the District Court discerned, notwithstanding the use of the designation "director" for individuals other than the actual members of the corporate Board of Directors, individuals such as Kirsch, were not directors. The actual Board of Directors was comprised of Messrs. Lieberman, Avni and Rosenthal (the latter being replaced in 1972 by Charles Horowitz). As used by Galaxy, the term "director" merely applied to certain employees responsible for particular functions within the corporation. Thus, notwithstanding that Kirsch had allegedly attended "director's meetings", it is clear that the meetings which he attended were not Board meetings but rather meetings of department heads.

The Franchise Contract

Plaintiff argues that Galaxy sold securities through a fraudulent promotional scheme. Defendants urge that the franchise contract was a contract exclusively for the sale of food, at retail, by franchisees to customers solicited by them and their independent sales force. The contractual obligations of the corporation involved only the servicing of the franchisees' customers. The contract conferred no other rights upon any individual, and the corporation did not obligate itself to permit franchisees to earn monies in any other manner.

However, plaintiff maintains that franchisees had the "right" to sell other franchises and receive commissions thereon, and that this "right" was an integral part of the purchased franchise. Thus, plaintiff argues that the corporation was selling both the right to market food and other franchises. It is argued that the "right" to sell other franchises converted the franchise interest into a security.

The only "rights" conferred upon the franchisees were those set forth in the contract (Exhibit 8) as confirmed by Paragraph III(1) of the franchise contract which reads as follows:

> "This agreement if and when accepted by Galaxy, constitutes the entire agreement between the parties and applicant acknowledges that any or all oral representations by either party hereto have been merged into this written agreement." (Appendix pp. 1858-1860).

Thus, the so-called "right", relied on by plaintiff, finds no support in the franchise agreement or the "Rules and Regulations" incorporated therein by reference (Exhibit "3" Appendix pp. 1852-1855).

As franchisees, Shevack and Kirsch assisted in the sale of additional franchises, not as a contractual right conferred upon them by their franchise contracts, but rather through a revocable privilege conferred upon them by the Galaxy Board of Directors.

Shevack received approximately $11,000.00 in commissions from the sale of approximately ten franchises (1491); Kirsch received the sum of $7,000.00 from the sale of three franchises (47).

It must be noted that each of the Galaxy promoters received many times this amount; Lee admitted receiving $92,000.00 in commissions and salary (491). It must also be noted that nearly half of all franchisees sold franchises and thereby received commissions (562).

"Opportunity" and "Step-Up" Meetings

Prospective franchisees were invited to attend "Opportunity Meetings". At these meetings, various speakers would communicate to those in attendance the benefits to

be realized from the food marketing program. The speakers would explain, and through the use of a blackboard illustrate that *if* a franchisee were able to acquire a certain number of customers and that *if* each customer were to purchase a given amount of food, he could realize a given amount of commission computed by multiplying the average order price (X) the number of customers (X) the commission rate. Prospective franchisees were further advised that while the corporation did not confer a contractual right upon them, it would temporarily permit those individuals desirous of selling franchises to realize commissions from their sale. Significantly, each prospective franchisee knew that the corporation had no obligation to allow him to sell franchises. Moreover, each knew that the corporation could revoke the privilege at any time and that, at best, the number of outstanding franchises (recognizing that there was a maximum number to be sold) was limited and could not be a basis for continued realization of earnings. Kirsch spoke at one "Opportunity Meeting" limiting his remarks to retail marketing of food; Shevack spoke at none.

Galaxy also held "Step-Up" Meetings where prospects were urged to join Galaxy in one of two franchisee capacities. The two franchises differed only in price and commission structure. The sale of a franchise, (the actual signing of the contract), was consummated at these meetings.

Galaxy also held "training sessions" where franchisees were instructed in techniques of selling. Kirsch delivered that portion of the session dealing with the retailing of food. Shevack did not speak at any of these meetings.

The source of the information communicated at "Opportunity Meetings" was "section one" of the "Distributor's Business Manual" which had been prepared by the prin-

cipals of Galaxy (Exhibit "3" Appendix pp. 1833-1844). The language of that section of the manual was communicated, in haec verba, to the prospective franchisees in attendance. Contained in that section was information concerning the ability of franchisees to earn commissions from the sale of franchises.

There is nothing in the record, however, to suggest that either Kirsch or Shevack had ever communicated these facts to those in attendance. Moreover, there is nothing to suggest that either Shevack or Kirsch knew that such a communication might constitute a violation of law. To the contrary, the testimony reveals that both Shevack and Kirsch had been advised by counsel for the corporation that the sale of franchises by franchisees was lawful. Moreover, at that time, there was no case law from which counsel could conclude otherwise.

The gist of the Commission's case is to the effect that the franchisees relied more upon the possibility of gaining reward from the sale of other franchises than upon the possibility of gaining reward from marketing food.

The testimony of the Commission's witnesses belies this argument, the Silvermans and McLean acknowledged that they relied upon the retail food program for future earnings and not on the sale of franchises (1003; 1115; 1460). Even Beck and Simmons, the two Commission witnesses who had sold franchises acknowledged that the "right" to sell was but a "privilege", was not a contractual right and was to be short-lived (918; 1146).

Moreover, there is nothing in the record to indicate that the right to sell franchises was limited to those who had purchased a franchise; to the contrary, the record discloses that Lieberman, who was not a franchisee, had earned large sums from the sale of franchises (491).

Demise of the Defendant Corporation

On or about November 28, 1973, following the commencement of this litigation, and some ten months after Kirsch and Shevack had withdrawn from participation in the corporation, Galaxy filed a voluntary petition in bankruptcy. As a consequence, all enrolled franchisees incurred a substantial loss of their purchase price.

This action was commenced after what appears to have been an abortive attempt by the corporation to market food through its franchisees; and it would appear that it was the unsuccessful attempt to market food, and the prospect of corporate bankruptcy, that prompted the initiation of this action.

Query whether the Securities and Exchange Commission would have considered that the defendant corporation was involved in the sale of a security had the spector of bankruptcy not appeared?

Plaintiff's Case

Although seven defendants were named in this action, only two, Shevack and Kirsch, proceeded to trial. Notwithstanding this, the record contains an enormous amount of testimony relating to the misconduct of others; and, without connecting this testimony to either Shevack or Kirsch, the wrongdoing of others is imputed to them. This occurred through failure of the Commission to alter the format of its presentation following notice to it that the other defendants would not be participants in the trial.

Throughout the course of the trial, the Commission endeavored to demonstrate that a circus atmosphere had been created at the various meetings to which franchisees and prospective franchisees were invited. To augment this atmosphere, participants had been instructed to clap

at specified moments and to otherwise create a carnival atmosphere. Beck's testimony lends expression to this motivational technique, and though the commission desired that an inference be drawn from his testimony to the effect that Kirsch had been a ready participant, on cross-examination, (989) it was disclosed that Kirsch had not participated. Rather, he acknowledged that the "instructors at the training sessions" were Katz, Lieberman, Kenneth Rosenthal and Charlie Horowitz".

When Mrs. Silverman, another of the Commission's witnesses, was asked who had allegedly misled her, she answered that at "Opportunity Meetings":

> "I can only remember two names of speakers. One was Steven Roth and one was George Padilla." (1434)

When asked whether Shevack had ever guaranteed her that she would earn a fixed sum of money, she answered "No he didn't" (1436). Of course her direct testimony was intended to convey the opposite inference.

Thus, notwithstanding the innuendo to the contrary, it is clear that neither Kirsch nor Shevack participated in any of the meetings at which alleged misstatements of facts were uttered save to the extent that Kirsch had, at some meetings, presented information relating to the prospective sale of products to the general public, facts which were, themselves accurate and true, at the time stated.

Notwithstanding this, the Court concluded that there had been material misstatements and omissions of fact relating to the sale of franchises and that Kirsch and Shevack had participated in the wrongdoing.

Assuming, arguendo, that misstatements had been made, or that material facts had been omitted, the Court in con-

cluding as it did ignored the specific language of paragraph III(2) of the franchise contract which clearly informed all franchisees:

"(2) . . .

a. Galaxy is presently in possession of no substantial assets.

b. Galaxy, presently, is not engaged in the retailing of foods or other supermarket items.

c. Galaxy is a starting company and it may never develop to the point whereby distributors may earn profits, salaries or commission from the sale of such items.

d. Applicant understands that his/her investment with Galaxy is a high risk investment, however, applicant has determined such investment, although with risk, is a sound venture investment with a new and emerging company, possessing a high potential for success." (Exhibit "8" Appendix p. 1860).

The foregoing language would certainly have alerted any prospective franchisees to false utterances to the contrary, made by others, if in fact made.

Obviously, Judge Neaher gave greater weight to the subjective analysis of what the witnesses believed had been stated as opposed to the objective language of the written contract executed by them. Still there is nothing in the record to demonstrate that the false information alleged to have been communciated originated with, or was expressed by, Kirsch or Shevack.

POINT I

The District Court lacked jurisdiction over the subject matter of this litigation.

We respectfully submit that the District Court lacked jurisdiction over the subject matter of this litigation. Jurisdiction has been predicated upon the fact that there is allegedly involved the sale of securities without benefit of registration. In accepting the Commission's argument, the lower Court ignored the principle enunciated by the United States Supreme Court in *S.E.C.* v. *W.J. Howey Corp.*, (1946) 328 U.S. 293, to the effect that:

> "The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." (At p. 301)

The crucial word of the *Howey* test is the word "solely".

The Commission, in furthering its position, has relied heavily on *S.E.C.* v. *Koscot Interplanetary, Inc.* (5th C.A., 1974) 497 F.2d 473, where it was held that:

> ". . . schemes in which promoters retain immediate control over the essential managerial conduct of an enterprise and where the investors' realization of profits is inextricably tied to the success of the promotional scheme",

will be deemed to involve the sale of a security thus conferring jurisdiction upon the Federal Courts.

Obviously, this Court is not bound by the decision in the *Koscot* case, supra, which erroneously departs from the law as enunciated by the United States Supreme Court.

The word "solely" contained in the *Howey* decision is a word of art. It leaves no room for exception; it leaves no room for judicial legislation.

The facts of the instant case make clear that the franchisees could not rely, alone, upon the activities of corporate management to gain for them profits through the operation of their franchises. It was incumbent upon each individual franchisee to set up his own independent operation, to solicit customers (or to engage others to solicit customers for him), to take steps necessary to promote the sale of products which the ultimate consumer would order, and to advertise. Galaxy was intended merely as the warehouser and deliverer of products to the individual entrepreneur's customers. The franchisee could not merely sit back and hope to derive dividends or profits.

In *United Housing Foundation* v. *Forman*, —— U.S. ——, 95 S.Ct. 2051 (1975), the Supreme Court, in keeping with its decision in the *Howey* case, supra, held that an "investment contract" and "an instrument commonly known as a security" are virtually the same. The Court further stated that where "a purchaser is motivated by a desire to use or consume the item purchased" the Securities Laws do not apply.

We need only ask what did the franchisee purchase and did he intend to utilize that which was purchased. The answer is that each franchisee, including the franchisee witnesses, had purchased a franchise for the marketing of food and intended to play an active role in that business.

If wrongdoing occurred, (and there is indication that wrongdoing did occur, though not attributable to Shevack or Kirsch) such wrongdoing cannot convert a non-security into a security as much as the Court may desire to assist in correcting a wrong.

In his decision, Judge Neaher concluded that the hub of the retail operation was Galaxy's warehouse. We submit that the warehouse was the hub of Galaxy's operation, not the operation of the individual franchisees who were intended to establish their own office locations, be they in their home, in an office building, or merely in the vehicle utilized by them in traveling from place to place in search of customers. We are not alone in our thinking as can be discerned from a reading of the decision in *Cobb* v. *Network Cinema Corp.*, (N.D.Ga., 1972) 339 F. Supp. 95, wherein the Court stated:

> "The Supreme Court and this Circuit clearly define 'an investment contract for the purposes of the Securities Act' as 'a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or third party.' *S.E.C.* v. *W.J. Howey Co.*, 328 U.S. 293 at 229 . . . *Roe* v. *United States*, 287 F. 2d 435 at 438 (5th Cir., 1971) . . . In an exhaustive opinion, it has recently been correctly concluded that franchise agreements of the type under investigation do not constitute 'investment contracts' and are beyond the ambit of the Securities Act. *Mr. Steak, Inc.* v. *River City Steak, Inc.*, 324 F. Supp. 640 (D. Colo., 1970). See also *Chapman* v. *Rudd Paint & Varnish Co., Inc.*, 409 F. 2d 635 (9th Cir., 1969). Under recognized standards it is plain to the Court the contract here does not rely solely on the efforts of others, and, consequently, is not a protected security under the Act."

Obviously, in any business, serviced by another, the demise of the "servicer" will cause damage to the firm being serviced. But the test of the *Howey* case, supra, goes not to the ultimate success of the servicing corpora-

tion but rather to that which is sold to the franchisee in the first instance. The franchise contract is dispositive of what was sold.

Even the Court in *Koscot*, supra, recognized that the performance of "undeniably significant" tasks by the franchisee precluded the franchise from being considered a security. If, as here, it is demonstrated that the franchisees had to perform significant tasks in order to realize profits, then the franchise cannot be construed a "security" from which one may realize profits "solely" from the activities of others. In his zeal to do justice where an apparent fraud had been committed, Judge Neaher ignored the actual nature of that which was sold, a right to market food which necessitated affirmative conduct by each franchisee lest he gain no benefit from his franchise. Where an individual must perform significant tasks in order to realize benefits, the Courts have repeatedly held that the franchise is not a "security". See *Mr. Steak* v. *River City Steak, Inc.*, 324 F. Supp. 640 (D. Colo., 1970), affirmed 460 F. 2d 666 (10th Cir., 1972); *Bitter* v. *Hoby's International, Inc.*, 498 F. 2d 183 (9th Cir., 1974); *Nash & Associates, Inc.* v. *Lum's of Ohio, Inc.*, 484 F. 2d 392 (6th Cir., 1973); *L.H.M. Inc.* v. *Lewis*, 371 F. Supp. 295 (D.N.J., 1974), affirmed 510 F. 2d 970 (3rd Cir., 1975); *Mitzner* v. *Cardet International, Inc.*, 358 F. Supp. 1262 (N.D.Ill., 1973); *Weibolt* v. *Metz*, 355 F. Supp. 255 S.D. N.Y., 1973).

State Courts have also accepted this principle. Thus, in *Hawaii* v. *Hawaii Market Center Inc.* (1971) 485 P. 2d 105, it was held that before a franchise would be construed as a security, two essential criteria would have to be satisfied:

a) That the franchisee would have to be controlled by corporate management *and*

b) The franchise fee would have to be shown to be utilized toward the capitalization of the corporate business.

We submit that the Securities and Exchange Commission previously adopted these same guidelines. See Securities Act Release No. 5211; Exchange Act Release No. 9381; CCH Fed. Sec. L. Rep. Paragraph 48446.

The Securities and Exchange Commission now wishes to depart from its own acceptance of these guidelines only because of the extent of damage visited upon those who had purchased franchises. That is not a valid basis for departure.

POINT II

The franchise is not a security because of the granting of the gratuitous privilege to sell additional franchises.

Throughout the course of these proceedings, the Commission has endeavored to infer the existence of a security by virtue of the granting of the privilege to franchisees to sell other franchises and receive remuneration on account thereof. To this end, it has relied on *S.E.C.* v. *Glenn W. Turner Enterprises, Inc.*, 474 F. 2d 476 (9th Cir., 1973), ignoring, however, that in the *Turner* case, supra, no usable commodity, such as food, was available for sale by the franchisee to the public.

The gist of this argument is that even if the franchise per se which granted the right to market food was not a security, in and of itself, then the "contractual" right conferred upon the franchisee to sell other franchises, would cause the otherwise non-security franchise to become a security.

The logic of this argument is difficult to comprehend for it presumes that the franchisees had, in the first instance, the contractual right to sell franchises which they did not.

Moreover, the Commission has relied on *S.E.C.* v. *United Benefit Life Insurance Co.*, 387 U.S. 202 (1967), where the Court held that a registration was required where one part of a two-part annuity program was admittedly a security under Federal statute, but held to be non-exempt.

Reliance upon that decision, however, likewise necessitates a presumption by the S.E.C. that either the franchise food program or the privilege to sell additional franchises was, in itself, a security. The presumption merely begs the question.

It is respectfully submitted, as can be gathered from the previous point, that the franchise for the sale of food is deemed not to be a security; and, we further respectfully submit that he gratuitous granting of a privilege to sell additional franchises and realize commissions therefrom is neither the sale of a right nor the creation of a contractual obligation.

POINT III

Absent proof of scienter, there can be no violation of the anti-fraud provisions of the Securities and Exchange Act of 1934.

In *Ernst & Ernst* v. *Hochfelder*, —— U.S. ——, 96 S. Ct. 1375 (1976), the Supreme Court held, in an action by a private litigant under Section 10b and Rule 10b-5, that liability and civil damages would not lie in the absence of an allegation and proof of scienter. The Court, in a footnote, declined, however, to consider the question whether scienter would be required in an action for injunctive relief.

Recently, Judge Robert J. Ward seized the opportunity to answer this question. In *S.E.C.* v. *Bausch & Lomb, Inc.*, C.C.H. Fed. Sec. L.R. No. 95,722 (September 16, 1976), where an injunction against the Chairman of the Board of Directors of the defendant for alleged violations of Rule 10b-5 was sought, the Court held that scienter must be pleaded and proved by the Commission as well as by a private litigant. The Court thereby discarded the old standard of negligence previously relied upon by the Commission.

Judge Ward reasoned that the Supreme Court, in the *Hochfelder* case, supra, in analyzing the legislative history of the promulgation of Rule 10b-5, the congressional intent to prevent "intentional wrongdoing", and the applicability of standards of negligence to other sections of the law, intended that scienter be pleaded and proved in an S.E.C. injunction proceeding.

In *Hochfelder*, supra, the Court defined scienter as "a mental state embracing intent to deceive, manipulate or defraud", and deliberately refrained from deciding whether even "recklessness" (however defined) would be sufficient to establish intent. In footnote (4) to his opinion, Judge Ward noted:

> "A careful analysis of *Hochfelder* has convinced this Court that the distinction is no longer to be drawn and that the identical standard under Section 10b and Rule 10b-5 must be applied whether the plaintiff is the SEC or a private litigant. Inasmuch as the Supreme Court did not address itself to a definition of reckless behavior which would suffice for culpability, however, the Second Circuit opinions which do deal with this issue, are helpful. Their language, coupled with the Supreme Court's emphasis that *scienter* means *intent* to deceive, manipulate or defraud leads to a conclusion that

> only what Judge Friendly has characterized as 'the kind of recklessness that is equivalent to willful fraud' [*S.E.C.* v. *Texas Gulf Sulphur Co.*, 401 F. 2d 833, 868 (2nd Cir. 1968) cert. den. sub. nom. *Coates* v. *S.E.C.*, 394 U.S. 976 (1969)] will serve as a basis for liability." (Emphasis in original)

In the Court below, Judge Neaher predicated 10b-5 liability upon alleged actual knowledge or reckless disregard for the truth by Kirsch and Shevack. He did not, however, find any willful fraud. Thus, we submit there was no violation of Rule 10b-5.

Judge Neaher found that Kirsch's and Shevack's "actual knowledge" or "reckless disregard for truth" was revealed by: a) their failure to clarify the corporation's meaning of "guaranteed investment"; b) their failure to divulge the percentages of monies derived from franchise sales payable to Galaxy employees; c) the fact that Galaxy was not then capable of full-scale marketing at retail through its franchisees and d) knowledge that a geographical limitation was imposed on the Galaxy operation.

The Court held that it was their obligation to inform prospective franchisees of these facts.

We submit that a) the so-called "guaranteed investment" was a creature of the corporation and neither Kirsch nor Shevack knew that the corporation did not intend to honor such guarantee; b) the obligation to divulge percentages to be paid on account of sales may exist in connection with the underwriting of securities but does not exist where a security is not being sold; c) the contract executed by the franchisees clearly set forth, better than any oral words could communicate, that the corporation was not marketing food on a regular schedule and d) the geographical limitation had to have been known through the contract's disclosure regarding the fact that the corporation was only limitedly marketing.

Judge Neaher noted, further, that neither Shevack nor Kirsch advised prospective franchisees of the failure by the corporation to create a contingency fund to assure fulfillment of the promise of guarantee. We submit that neither Shevack nor Kirsch had anything to do with the accounting arrangements utilized by the defendant corporation. Nothing in the record even suggests the contrary.

To determine whether one has intended to defraud, it must first be decided what it was he was required to do. The fact that one might have done a particular thing does not suggest that his failure to do that is intended to cause harm. We submit that there was much that neither Shevack nor Kirsch did; the question is whether they were required to do these things. Again, we submit that they were not.

CONCLUSION

The sale of a franchise for the retail distribution of food is not a security; the granting of a privilege to earn commissions from the sale of additional franchises is not a security; the District Court, accordingly, lacked jurisdiction over the subject matter of this suit.

Assuming arguendo, that the District Court had jurisdiction, in the absence of proof of scienter, there is no violation of the anti-fraud provision of the Securities and Exchange Act of 1934.

The judgment of the lower Court should be reversed and judgment in favor of Defendants-Appellants should be directed.

Respectfully submitted,

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Attorneys for Defendants-Appellants
Shevack and Kirsch

376—Affidavit of Service by Mail

United States Court of Appeals
For the Second Circuit

The Reporter Co., Inc., 11 Park Place, New York, N. Y. 10007

Securities and Exchange Commission
Plaintiff-Appellee

against

Galaxy Foods, Inc., Arthur Lieberman a/k/a Arty Lee, Ralph Avani, Charles Horowitz Bruce Katz, Steven Roth, Mark Glazer, et al.
Defendants

Irwin Donald Kirschenblatt et al.
Defendants-Appellants

State of New York, County of New York, ss.:

Raymond J. Braddick, agent for Goidel Goidle & Helfenstein Esqs. being duly sworn deposes and says that he is the attorney for the above named Appellant herein. That he is over 21 years of age, is not a party to the action and resides at Levittown, New York

That on the 10th. day of December, 1976, he served the within Appendix Vols 1, II, III, IV & Exhibit Volume, and Brief of Appeallants

upon the attorneys for the parties and at the addresses as specified below

William D. Moran Esq.
Regional Administrator
Securities and Exchange Commission
Attorney for Plaintiff-Appellant
26 Fed ral Plaza
New York, New York

by depositing 3 true copies to each of the same securely enclosed in a post-paid wrapper in the Post Office regularly maintained by the United States Government at
90 Church Street, New York, New York
directed to the said attorneys for the parties as listed above at the addresses aforementioned, that being the addresses within the state designated by them for that purpose, or the places where they then kept offices between which places there then was and now is a regular communication by mail.

Sworn to before me, this 10th. day of December, 19 76

Raymond J. Braddick

Roland W. Johnson

ROLAND W. JOHNSON,
Notary Public, State of New York
No. 4509705
Qualified in Delaware County
Commission Expires March 30, 1977